



**Gene Walborn**  
Director

# Montana Department of Revenue



**Steve Bullock**  
Governor

April 22, 2019

Bwembya Chikolwa  
1025 Eldorado Blvd.  
Broomfield, CO 80021  
Mailstop: (Broomfield, 23-506)

Re: Response to Comments on the 2019 Capitalization Rate Study,  
Telecommunications

Dear Mr. Chikolwa:

The department would like to thank you for taking the time to review our study and for providing additional information for us to consider. The following additional information was provided: your submission email received April 5, 2019, which included a letter and attached appendices that detailed what areas of our study should get further consideration as well as a copy of the draft Weighted Average Cost of Capital Study for Ad Valorem Taxation for Wireline Carriers completed by Duff & Phelps.

The following sections of this letter will detail the adjustments made or not made for each request detailed in your submission letter.

## *Capital Structure*

It was argued that the percentage of debt-to-equity for our selected capital structure was too low, and it was suggested our debt percentage be closer to 60%. This was supported by recommending we consider adding additional guideline companies to our study as well as to consider the impact that AT&T and Verizon have on the study.

In considering this request the department did further analysis of our selected guideline companies. Although we did not find that adding additional guideline companies was appropriate we determined that AT&T and Verizon should not be included in this study. Because of their considerable difference in size<sup>1</sup> and the impact they have on all aspects of the study, the department determined that a separate study should be developed for these companies.

With AT&T and Verizon removed we agree that the capital structure should be 60% debt and 40% equity.

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<sup>1</sup> For example, in the original study AT&T and Verizon made up 67% of the total invested capital of all companies in the study.  $[(412M + 379M)/1,182M]$

### *Operating Leases*

Two concerns were raised related to operating leases. The first was due to ASU 2016-02 leases will appear on the balance sheet. When leases appear on the balance it would be inappropriate to then still adjust our study for leases as this would be adjusting for leases twice. The second concern was related to why adjustments are being made for operating leases to begin with as property taxes are being paid by the owner as well as the difficulty in adjusting allocations for operating leases.

The department has done extensive research on this topic and has concluded adjusting for operating leases is appropriate if not required to ensure companies are treated equitably. Operating leases are commonly referred to as off-balance sheet financing, meaning that the leased asset and the associated liability of the future required rent payments are not included on the company's balance sheet. In addition the rent payment includes a component of interest that is treated as an operating expense as opposed to an interest expense. Finally, the change in accounting standard referenced in your letter supports the importance of adjusting for operating leases as that is what will be required by companies on a go forward basis.

However, the department does agree that once companies start recognizing operating leases on their balance sheets and adjusting their income statements that we will no longer need to make a separate adjustment to the capital structure to adjust for operating leases. From reviewing the financial statements of the guideline companies, it appears that companies will be adjusting their 2019 financial information for operating leases and thus it is likely an adjustment to the capital structure will not be necessary in the department's 2020 Capitalization Rate Study.

### *Cost of Debt*

Additional information was provided in support of a recommended increase to the selected cost of debt.

With the removal of AT&T and Verizon the study did indicate an adjustment to the cost of debt was necessary. Based on further analysis it was determined the appropriate debt rating fell between Ba and B. As a result, the department put 50% weight on the cost of debt of a Ba rated security and 50% weight on the cost of debt of a B rated security. Our final concluded yield to maturity on debt was increased from 6.89% to 7.55%.

The removal of AT&T and Verizon also resulted in an increase to the indicated current yield on debt that is used in our direct income approaches. Our final concluded current yield on debt was increased from 5.60% to 6.00%.

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### *Cost of Equity*

It was also suggested that our cost of equity is understated because of the increasing debt levels in the telecommunications industry.

As a result of removing AT&T and Verizon from the study, an increase in the cost of equity was warranted. Our final concluded cost of equity increased from 10.30% to 11.00%.

Again, I would like to thank you for your comments and the additional information you provided for our consideration and I look forward to any further discussion we may have throughout the 2019 appraisal season.

Our final 2019 Cost of Capital Study for Telecommunications and the 2019 Cost of Capital Study for Large Telecommunications can be found at:

<https://mtrevenue.gov/publications/cap-rate-studies/>

Sincerely,

A handwritten signature in black ink, reading "Doug Roehm". The signature is fluid and cursive, with a long horizontal stroke at the end.

Doug Roehm, Unit Manager  
Centrally Assessed & Industrial Properties  
Montana Department of Revenue  
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